

THE MECHANISMS OF CONTROL

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I. INTRODUCTION

Regardless of the form it takes, control is a central and defining feature of organizations, which are the economic and social structures that enable individuals' work to be coordinated toward ends beyond any individual's capability, however talented and industrious that individual may be.¹ Moreover, control is a defining feature in the legal definition of agency.² A principal has the right on a continuing basis to control the methods by which the agent achieves results, as opposed to the right simply to assess the results achieved against benchmarks established by contract. In an agency relationship, the agent has a duty to follow the principal's direction even when the principal has previously agreed not to intervene in the agent's exercise of discretion.³ Significant legal consequences follow from the conclusion that a particular relationship is one of agency. An agent has power to commit the principal to transactions within the scope of the actual or apparent authority created by the agency relationship,⁴ and the principal is vicariously liable for instances of misconduct committed by the agent when acting within the scope of the relationship, including physical injuries caused by the agent's negligence

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1. See generally JAMES S. COLEMAN, *FOUNDATIONS OF SOCIAL THEORY* (1990); Robert Flannigan, *The Economic Structure of the Firm*, 33 *OSGOODE HALL L.J.* 105, 113-19 (1995).

2. See *RESTATEMENT (SECOND) OF AGENCY* § 1 (1958) (defining agency as "the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.").

3. See *id.* § 14 cmt. a (observing that "the agent is subject to a duty not to act contrary to the principal's directions, although the principal has agreed not to give such directions."). Section 33 explains this point by characterizing agency as an "ambulatory power," such that the scope of the agent's authority is to be assessed at the time the agent acts: the agent "is authorized at any given moment to do, and to do only, what he reasonably believes the principal desires him to do, in the light of what he knows or should know of the principal's purpose and the existing circumstances." *Id.* § 33 cmt. a. The agent's duty of obedience is not diminished because the principal's change of mind or change in instructions breaches the principal's contract with the agent. See *id.* § 33 cmt. b.

4. See *id.* § 140.

when the principal's right of control encompasses the agent's physical conduct or circumstances under which the agent performs the work.⁵ Likewise, in the corporate context, significant legal consequences follow if a shareholder exercises control over a corporation's operations or over its directors.

Fundamental though it is, the concept of control is puzzling in two major respects. First, although control is clearly central to the legal concept of agency that encompasses the key mechanism for a functioning organization, the content of the concept is highly variable. The distinguishing features of control, domination, and influence more generally are far from clear. "Control" more often appears as a conclusory label than as a term with determinate meaning. What "control" means, and what consequences it carries, vary greatly from context to context. For example, the conclusion that a substantial shareholder controls or dominates the corporation's directors does not by itself make the shareholder liable for the corporation's obligations. Second, it is intriguing that the exercise of control in the corporate context often seems to provoke disapproval. Judicial opinions and academic literature frequently characterize the exercise of control in terms suggestive of moral disapproval, even in the absence of any criticism of the specific tactics used by the dominant shareholder to effect its control. In *Zahn v. Transamerica*,⁶ for example, the court characterized the relationship alleged in the complaint between the corporation's directors and the dominant shareholder as that of a "puppet" and "puppeteer."⁷ And in his recent analysis of caselaw doctrines governing "piercing the veil" of a corporation's separate legal existence to impose liability on shareholders, Professor Phillip Blumberg concludes that a common feature of the leading doctrines is the "excessive exercise of 'control' by the dominant parent or shareholder," plus the existence of fraud or inequitable conduct.⁸ The doctrines differ in whether the subervient corporation is termed the "alter ego" or "instrumentality" of the

5. See *id.* § 219 (liability for torts committed by servants); §§ 250-54 (liability for torts committed by nonservant agents).

6. 162 F.2d 36 (3d Cir. 1947).

7. *Id.* at 46 (noting that directors were "instruments" of stockholder; directors could not and did not exercise independent judgment in voting in favor of call of class of redeemable stock, which benefited shareholder holding majority of class of nonredeemable stock).

8. Phillip I. Blumberg, *The Increasing Recognition of Enterprise Principles in Determining Parent and Subsidiary Corporation Liabilities*, 28 CONN. L. REV. 295, 331 (1996); see also Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1071 (1991) (noting that mere stock ownership and overlap of officers and directors is insufficient to rebut presumption of limited liability; "[m]ore pejorative conduct is required," such as undercapitalization, disregard for corporate formalities, or, most powerfully, "demonstrations of lack of substantive separation of the corporation and its shareholders, and intertwining in the activities of the corporation and its shareholders.").

shareholder. On the other hand, a shareholder's failure to exercise control does not appear to be a basis for culpability, even when an assertion of control would be beneficial.⁹

In this article I explore the mechanisms through which control is exercised in the corporate context. My hope is to flesh out the meaning of the concept in application. The article links the consequences that follow the exercise of control to differences among the mechanisms of control, to normative consequences of the corporate form itself, and to judicial deference to autonomy in private sector decisions to create institutions and structure relationships among them. My perspective is heavily shaped by presuppositions about corporate law that are common in the United States.¹⁰ The article draws upon cases involving two different scenarios: (1) a shareholder's exercise of control is claimed to be a basis for imposing liability on the shareholder for corporate misconduct or transactions entered into by the corporation, and (2) a shareholder's exercise of control over directors dislodges the business judgment rule when a minority shareholder challenges a transaction between the corporation and the controlling shareholder. In both scenarios, I argue that the terminology of "agency" should be used only with precision and care. In relationships between a controlling shareholder and the corporation, I propose a shift in terminology to better characterize the role of directors in many instances. My focus throughout is on disputes governed by common law doctrines, not specialized regulatory statutes.

II. CONTROL WITHIN AGENCY RELATIONSHIPS

In the paradigmatic agency relationship, the agent undertakes service on behalf of the principal, who has the right to direct the agent's execution of the service. The principal may provide interim instructions to the agent who, as a fiduciary, has a duty to interpret and act on the instructions to further the principal's interests known to the agent. The principal's ability to control the agent by specifying the service to be provided, by designing the agent's incentive system, and by providing interim instructions to the agent, underlies the principal's accountability for consequences of the

9. See *In re American Honda Motor Co., Inc. Dealerships Relations Litig.*, 958 F. Supp. 1045, 1051-52 (D. Md. 1997) (holding that parent corporation is not liable for misconduct of subsidiary when parent allegedly had knowledge of misconduct and failed to exercise control); see also *In re Silicone Gel Breast Implants Products Liab. Litig.*, 837 F. Supp. 1128, 1139-40 (N.D. Ala. 1993) (holding that parent corporation's failure to exercise control over subsidiary does not create vicarious liability for defective product manufactured by subsidiary).

10. In particular, the assumption of autonomous corporate legal personality dominates my approach. See José Engracia Antunes, *Liability of Corporate Groups*, in 10 *STUDIES IN TRANSNATIONAL ECONOMIC LAW* 155-57, 292-94 (1994).

agent's interactions with third parties.¹¹ The paradigm presupposes that the relationship between the principal and the agent is consensual, close, and interactive. Within the paradigm, direct instruction is the initial mechanism of control. Agency doctrine readily encompasses relationships in which the principal is an organization, not an individual. In an organizational principal, internal hierarchies define rights of direction and duties of compliance.

A. *Indirect and Direct Mechanisms of Control*

In contrast, control assumes very different forms in the paradigmatic relationship between equity investors and a corporation. Shareholders' control is often latent and indirect in form. Corporate law itself allocates to shareholders only the power to elect directors,¹² and under some circumstances, to remove directors once elected,¹³ and to adopt or reject fundamental transactions proposed by directors.¹⁴ Holding a majority of voting power does not in itself place a shareholder in a position of active control. If the shareholder assumes no additional role within the corporation, the shareholder is not a direct participant in operational decisions or in the formulation of strategic policy. Nonetheless, shareholders hold power to control in a latent form because they may be able to remove directors, and in all events may replace the incumbents if they resign or when their terms expire.¹⁵

11. The classic epigrammatic statement of this point is "[l]iability follows control." Warren A. Seavey, *The Rationale of Agency*, 29 YALE L.J. 859, 879 (1920). The fact that the principal expects to benefit from appointing the agent is, of course, an additional justification for the principal's liability.

12. See, e.g., DEL. CODE ANN. tit. 8, § 211(b) (1991); MODEL BUS. CORP. ACT § 8.03(d) (1984).

13. See DEL. CODE ANN. tit. 8, § 141(k); MODEL BUS. CORP. ACT § 8.08.

14. See DEL. CODE ANN. tit. 8, § 242(b)(2) (amendment to certificate of incorporation); *id.* § 251 (merger transaction); *id.* § 271 (sale of all or substantially all assets); *id.* § 275(b) (voluntary dissolution); MODEL BUS. CORP. ACT § 10.04(a) (amendment to articles of incorporation); *id.* § 11.03(e) (plan of merger or share exchange); *id.* § 12.02(e) (sale of all or substantially all assets); *id.* § 14.02(e) (voluntary dissolution). Under the Model Business Corporation Act, a provision in the corporation's articles or bylaws, or in a unanimously-adopted shareholder agreement may alter fundamental norms of corporate governance. See MODEL BUS. CORP. ACT § 7.32(b). Such a provision may "restrict[] the discretion or powers of the board of directors," *id.* § 7.32(a)(1), and may "govern[] . . . the exercise or division of voting power by or between the shareholders and directors," *id.* § 7.32(a)(4).

15. Shareholders who hold insufficient shares to enable them to remove or replace directors may nonetheless be influential. In her recent autobiography, Katharine Graham credits Warren Buffett with providing helpful advice after his firm, Berkshire Hathaway, purchased a substantial but noncontrolling block of shares in the Washington Post Co. See KATHARINE GRAHAM, *PERSONAL HISTORY* 511-15, 530-37 (1998). See generally Deborah A. DeMott, *Agency Principles and Large Block Shareholders*, 19 CARDOZO L. REV. 321 (1997) (discussing legal principles applicable to substantial noncontrolling shareholders, with particular illustrations based on Berkshire Hathaway). Mrs. Graham's relationship with Mr. Buffett is best appreciated in the context of the company's historical patterns of control, themselves reflecting familial circumstances. Katharine Graham became the company's controlling shareholder following the suicide of her husband, Philip, in 1963. Her father, Eugene Meyer, structured share ownership in the company so that Philip would hold a larger block of shares than

Incorporated shareholders that hold a majority of the shares in another corporation clearly exercise indirect power through a variety of mechanisms. In relationships between parent corporations and subsidiaries, the parent may exercise control indirectly by allocating capital, by prescribing operating and financial policies, and by choosing or vetoing the choice of key personnel within the subsidiary. In Professor Edward Herman's terminology, much of the shareholder's control stems from the power to constrain by limiting decision choices.¹⁶ Capital allocations limit the extent of the subsidiary's capital expenditures; if allocations are made in response to project-specific requests from the subsidiary, an internal system of capital supply gives the parent veto power. Likewise, if less sharply, the ability to set general financial and operational policy channels decisions made by the subsidiary's management in a manner that tends to exclude some otherwise possible decisions. Indeed, direct operational control has a limited span of effectiveness, regardless of the setting. To manage diversified activities within a single large organization, top managerial attention tends to diffuse away from short-run activity and to focus on considerations of longer-range strategy and resource allocation.¹⁷ To maintain overall management effectiveness, operational managers must be subject to constraints that assure their accountability for the results they achieve and the uses they make of the organization's resources.¹⁸

Latent power, like a sleeping tiger, may always awake and assert itself in more active and direct forms. Such an awakening is illustrated by the experience of Banc One, the seventh-largest bank holding company in the United States. In the 1980s and early 1990s, Banc One acquired over one hundred banks using a friendly approach that embodied an "uncommon partnership" with each acquired bank. Each kept its own charter and management, which ran the bank essentially autonomously, developing products, setting certificate-of-deposit rates, designing computer systems, and hiring and firing personnel. Banc One's headquarters set performance

Katharine, on the premise that "no man should be in the position of working for his wife." GRAHAM, *supra*, at 180-81. When the company went public in 1971, Mrs. Graham retained control of a majority of the class A shares, which as a class have voting control within the company, while her children controlled the remainder of the class A. *See id.* at 441-42. Through Berkshire Hathaway, Mr. Buffett acquired about 10% of the class B shares in 1973. *See id.* at 442. Mrs. Graham credits Mr. Buffett with teaching her the fundamentals of business and finance, *see id.* at 534, and, the reader might fairly infer, with enabling her to overcome the gender-dominated reactions to her, as a controlling stockholder and newspaper executive, that the history of her prior relationships with the company likely created.

16. EDWARD S. HERMAN, *CORPORATE CONTROL, CORPORATE POWER* 19 (1981); *see also* Alfred F. Conard, *Control, Responsibility and Abdication: A Dilemma of Securities Regulation*, 17 J. CORP. L. 539, 550 (1992) (noting that in parent-subsidiary relationships, although proximate operational control resides in subsidiary's executives, executives of parent may have ultimate operational control).

17. *See* OLIVER E. WILLIAMSON, *THE MECHANISMS OF GOVERNANCE* 82 (1996).

18. *See id.*

targets, but gave local management much leeway in meeting them: Banc One's chairman would personally contact the local bank's president to practice what insiders characterized as "management by suggestion."¹⁹ In late 1994, heavy losses in derivatives, along with the cumulative cost burden created by maintaining so many separate systems, led Banc One's chairman to shift to a more centralized control system that stresses system and product uniformity. Local bank officers now receive directives, not suggestions, from headquarters and deal with a team of central executives, not directly with the chairman. In short, the shareholder's latent power of control assumed a more active and operational form, and the greater urgency created by specific directives imposed by executives at headquarters replaced the chairman's personalized style of "management by suggestion."²⁰

Even in its more activist modes, the control exercised in such corporate structures would not typically make the relationship between the parent corporation and its subsidiary one of agency, and it would not satisfy the control-related requirements to pierce the corporate veil on the basis that the subsidiary is the "alter ego" or "instrumentality" of the parent. Many cases develop the underlying doctrines through murky statements that contain an occasional outcrop of clarity.²¹ Adding to the murk is the similarity among terms like 'agency,' 'instrumentality,' and 'alter ego.' One starting point is to distinguish between the concept of agency, in which the right of control is a constitutive element, and the less tightly defined concept of domination. Agency presupposes the existence of two separate persons; an agency relationship is consensual and does not collapse the personality of the agent into that of the principal. An agency relationship may be selective, so that the scope of the agent's actual or apparent authority extends to some matters but not to others.²² One corporation may be the agent of another regardless of the presence or absence of an ownership relationship between them. In the absence of actual authority, or the appearance of authority for which the principal is respon-

19. Matt Murray, *After Long Overhaul, Banc One Now Faces Pressure to Perform*, WALL ST. J., Mar. 10, 1998, at A1.

20. *Id.*

21. Apologies to George Orwell, who, observing that "[t]he whole tendency of modern prose is away from concreteness," noted that nonetheless "outcrops of simplicity will appear here and there" GEORGE ORWELL, *Politics and the English Language*, in A COLLECTION OF ESSAYS 170 (1954).

22. Imposing liability based on agency requires a close fit between the cause of action and the relationship between the alleged principal and agent. See *Mobil Oil Corp. v. Linear Films, Inc.*, 718 F. Supp. 260, 271-72 (D. Del. 1989) (noting that a subsidiary could not have acted as parent's agent in infringing plaintiff's patents when formation of parent, and acquisition of subsidiary stock, followed subsidiary's use of patented process by five years).

sible,²³ the relationship is not one of agency.²⁴ If a third party reasonably believes one corporation to be the agent of the other on the basis of the apparent principal's conduct, the doctrine of apparent agency—a form of estoppel—protects the third party's justifiable reliance on that appearance.²⁵ In contrast, domination collapses one legal personality into another. It is difficult to see how domination would operate selectively, collapsing as to one aspect of the corporations' relationship but not another, unless the dominated corporation's personality can be subdivided. Finally, domination presupposes that the persons in question are linked by ownership or some other relationship that gives one leverage over another. A finding of domination does not presuppose that one party had a right to control the other, but rather that control was in fact exercised, and exercised to a pervasive degree. Although some opinions reflect these distinctions between concepts, others do not.²⁶

23. Documents generated and distributed by the subsidiary, standing alone, do not confer authority on the subsidiary to act as the parent's agent, nor do they evidence apparent authority when the parent neither authorized the documents nor gave the appearance of having done so. See *Fletcher v. Atex, Inc.*, 68 F.3d 1451, 1461 (2d Cir. 1995).

24. In *Royal Industries Ltd. v. Kraft Foods, Inc.*, 926 F. Supp. 407, 414 (S.D.N.Y. 1996), the court denied the plaintiff's motion for summary judgment, finding the presence of an issue of material fact concerning the existence of an agency relationship between a parent corporation and its wholly-owned Swiss subsidiary. The subsidiary's responsibilities included negotiating sales agreements with customers. The parent performed the agreements and the customers paid the parent directly, a pattern that resembles a prototypical principal-agent relationship. At odds with this characterization, the parent's logistics manager testified that when the parent issued an invoice to a customer, it was only offering to sell goods, not acknowledging the existence of a contract entered into by the subsidiary on the parent's behalf. The court subsequently granted the defendant's motion for summary judgment on the basis that no material issue of fact existed as to whether the subsidiary had actual or apparent authority to enter into commitments binding the parent to sell its product. See *Royal Industries Ltd. v. Kraft Foods, Inc.*, No. 94 Civ. 9334(CHS), 1998 WL 67671 (S.D.N.Y. Feb. 18, 1998).

25. See PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: TORT, CONTRACT, AND OTHER COMMON LAW PROBLEMS IN THE SUBSTANTIVE LAW OF PARENT AND SUBSIDIARY CORPORATIONS* §§ 8.02, 14.04 (1987).

26. The best-known conflation of agency with domination is Judge Cardozo's: "Domination may be so complete, influence so obtrusive, that by the general rules of agency the parent will be a principal and the subsidiary the agent. Where control is less than this, we are remitted to the tests of honesty and justice." *Berkey v. Third Ave. Ry.*, 155 N.E. 58, 61 (N.Y. 1926). Compare *Japan Petroleum Co. (Nigeria) Ltd. v. Ashland Oil, Inc.*, 456 F. Supp. 831, 840 (D. Del. 1978) (recognizing that agency theory of liability exists independently of theories piercing corporate veil in parent-subsidiary context; plaintiff not required to prove fraud or inequity to premise parent's liability on agency relationship with subsidiary) and *Phoenix Canada Oil Co. v. Texaco, Inc.*, 842 F.2d 1466, 1477 (3d Cir. 1988), *cert. denied*, 488 U.S. 908 (1988) (finding that parent completely dominated subsidiary is unnecessary to prove an agency relationship; proponent of parent's liability must establish relationship between agency and cause of action, a showing not necessary under veil-piercing theory of liability) with *Kashfi v. Phibro-Solomon, Inc.*, 628 F. Supp. 727, 735 (S.D.N.Y. 1986) (explaining test for determining whether corporation acted as agent is same test imposed under doctrine of piercing corporate veil). See also BLUMBERG, *supra* note 25, §§ 6.06.1, 9.03.3, 18.02.17 (noting that some but not all New York cases impose liability on parent under "agency" theory that rests simply on parent's excessive exercise of control). See generally JAMES D. COX ET AL., *CORPORATIONS* § 7.16 (1996) (analyzing differences among veil-piercing standards).

The standard of control requisite to finding that one corporation dominated another is stringent. In an influential statement in 1929, Judge Learned Hand stated in *Kingston Dry Dock Co. v. Lake Champlain Transportation Co.*²⁷ that “[c]ontrol through the ownership of shares does not fuse the corporations, even when the directors are common to each. One corporation may, however, become an actor in a given transaction, or in part of a business, or in a whole business . . . and will be legally responsible.”²⁸ A corporation “becomes an actor” under *Kingston Dry Dock* when it “take[s] immediate direction of the transaction through its officers, by whom alone it can act at all.”²⁹ The parent exercises control in the requisite form, wrote Judge Hand, only if it intervenes directly in the transaction, “ignoring the subsidiary’s paraphernalia of incorporation, directors, and officers.”³⁰ What matters is the form or mechanism through which control is exercised, not the substance. *Kingston Dry Dock* distinguishes between domination and two additional possibilities. A parent corporation may establish a consensual relationship of agency with its subsidiary, just as it may with an unaffiliated corporation.³¹ Separately, the opinion recognizes the possibility of direct participation by the parent in subsidiary-level activity, which Judge Hand’s formulation suggests might extend to some activities but not to others.³²

Prescribing constraints to limit decision choices does not create an agency relationship, nor does it establish that the parent has become an actor in specific transactions. Consider in this connection the control mechanisms used by the parent corporation in *Levien v. Sinclair Oil Corp.*,³³ in which the plaintiff was a minority shareholder in Sinclair’s Venezuelan subsidiary.³⁴ Sinclair’s chief executive officer selected or approved the officers of its subsidiaries; Sinclair’s policy was to give the Venezuelan subsidiary “quite liberal autonomy in conducting its affairs”

27. 31 F.2d 265 (1929).

28. *Id.* at 267.

29. *Id.*

30. *Id.*

31. *See id.* The question is whether the parent and the subsidiary have acted in a manner that manifests consent to the creation of an agency relationship between them. *See Comind, Companhia de Seguros v. Sikorsky Aircraft Div. of United Techs. Corp.*, 116 F.R.D. 397, 404-05 (D. Conn. 1987).

32. The prospect that direct participation might have focused consequences is relevant to regulatory structures. For example, liability based on a shareholder’s direct participation in an activity, limited to that activity, underlies the parent’s liability under CERCLA, because the statutory language imposing liability on facility owners and operators for the costs of cleaning up hazardous waste applies only to persons who participate in the management of a facility. *See* 42 U.S.C. § 9601(20)(A) (1994). The EPA’s 1992 rules emphasize actual participation in the facility’s management or operational affairs. *See* 40 C.F.R. § 300.1100 (1992) (repealed 1995).

33. 261 A.2d 911 (Del. Ch. 1969), *rev’d in part & aff’d in part*, 280 A.2d 717 (Del. 1971).

34. Indeed, the parent respected the subsidiary’s corporate paraphernalia by entering into output contracts to purchase its crude oil, which the parent breached. *See Levien*, 280 A.2d at 722-23.

subject to aggregating the subsidiary's crude oil output into the larger organization to facilitate sales and other organizational uses.³⁵ Even in the absence of specific directives from Sinclair, it is likely that the Venezuelan subsidiary's officers and directors (all nominated by Sinclair³⁶) were well attuned to achieving a good fit between their decisions and the interests of the larger organization. Sinclair's exercise of control did not, however, require it to ignore the subsidiary's paraphernalia of separate corporate existence in the direct manner required by *Kingston Dry Dock*.

Whether the parent has ignored the subsidiary's "paraphernalia" is likely a question of degree. The fact that the parent's relationship with the subsidiary has aspects or qualities not typical of arms-length dealings is insufficient. The mechanisms through which the parent exercises control shape the texture of the relationship and, in turn, the court's willingness to conclude that the subsidiary and the parent operated as one. Moreover, the formulation in *Kingston Dry Dock* may not reflect a sufficient appreciation of the differences between natural persons and organizations. Professor Robert Thompson argues that the definition of "direct participation" applicable to a parent corporation should not be as stringent as the standard applicable to individual managers.³⁷ The parent benefits through its relationship with the subsidiary and controls the subsidiary, while the individual manager's connection is only a job. Moreover, the parent may diffuse control, exercising it effectively but less visibly than would an individual.

B. *Non Arms-Length Relationships and Transactions*

A recent pair of cases, decided by the same court, illustrate the distinctions among mechanisms of control that courts treat as dispositive when the relationship has elements that would not typify an arms-length relationship between unrelated corporations. At issue in each case was the liability of a parent corporation for claims made against a wholly-owned subsidiary, arising from its manufacture and sale of silicone gel breast implants. In the first case, the court granted the defendants' motion for summary judgment as to claims against Dow Chemical Co. and Corning Inc., sole shareholders in an incorporated joint venture, Dow Corning

35. *Levien*, 261 A.2d at 914.

36. *See Levien*, 280 A.2d at 719.

37. Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1, 39 (1994). A related formulation for determining whether the parent should be liable for subsidiary-level conduct would look to "whether the particular business decision(s) from which the concrete liabilities in dispute arose was (were) taken under the autonomous decision-making authority of the subsidiary corporation or under the control exercised by the parent." ANTUNES, *supra* note 10, at 495. Antunes proposes shifting the burden of proof on control to the parent and would include as indicia of control parent-level product design and marketing decisions, among others. *Id.* at 496.

Corp.³⁸ Dow and Corning collaborated with Dow Corning in research and product development, a practice the court found not to be typical for wholly-independent companies.³⁹ But when Dow transferred employees for this purpose to Dow Corning, Dow Corning reimbursed Dow, while resulting patents were assigned to Dow Corning. Second, Dow Corning's finances reflected a policy of retaining a relatively high percentage of earnings as opposed to distributing earnings as dividends. Both parents lent money to the subsidiary but on terms not disadvantageous to it.⁴⁰ Third, the directors of the subsidiary (all current and former directors or officers of the parents) reported potential product liability problems to their appointive shareholders, which the court found "altogether appropriate."⁴¹ In general, the subsidiary's directors carried out business dealings with the parents "with due regard for the separate existence and interests of each, with all necessary corporate formalities being observed."⁴²

The second case reached a different outcome. The court denied the motion for summary judgment made by Bristol-Meyers Squibb Co. ("Bristol") as to claims involving its wholly-owned subsidiary, Medical Engineering Corp. ("MEC").⁴³ Bristol's in-house counsel reviewed and approved packaging inserts for MEC's product, along with other information given to physicians,⁴⁴ and the product bore Bristol's name.⁴⁵ MEC's financial practices included transferring cash it received to Bristol for an

38. See *In re Silicone Gel Breast Implants Products Liab. Litig.*, 837 F. Supp. 1128 (N.D. Ala. 1993). As it happens, Dow was unsuccessful on its motion for summary judgment on direct claims against it. See *In re Silicone Gel Breast Implants Products Liab. Litig.*, 887 F. Supp. 1447 (N.D. Ala. 1995). The direct liability theory was that Dow tested silicone but did so negligently; Dow Corning relied on Dow's testing and did not conduct additional research on silicone safety before marketing breast implants. See *id.* at 1460.

39. See *In re Silicone Gel Breast Implants Products Liab. Litig.*, 837 F. Supp. at 1135.

40. See *id.* at 1136. Relatedly, the court found that Dow Corning was not undercapitalized. See *id.* at 1137. Dow Corning and its parent corporations nonetheless had unusual financial ties. Dow and Corning furnished stock to Dow Corning to use in stock option and stock purchase plans for employees. See *id.* at 1135-36. Although the court characterized this practice as representing "an involvement that would not ordinarily be found with wholly-independent corporations," it assessed the practice as the obvious solution to Dow Corning's wish to provide its employees with a typical form of compensation keyed to publicly-traded stocks. *Id.* at 1136. Holding options on Dow or Corning stock should ally the financial interests of subsidiary employees with those of the parent corporations. Thus aligning the interests of the subsidiary employees is indicative of economic integration. Some cases imposing liability on the parent for tort-based obligations of a subsidiary involve subsidiaries dependent on the parent for administrative functions, including support of pension or profit-sharing plans. See BLUMBERG, *supra* note 25, § 10.06. In contrast, Dow Corning appears to have administered its stock option plan itself, using parent corporation stock.

41. *In re Silicone Gel Breast Implants Products Liab. Litig.*, 837 F. Supp. at 1136.

42. *Id.* at 1138.

43. See *In re Silicone Gel Breast Implants Products Liab. Litig.*, 887 F. Supp. 1447 (N.D. Ala. 1995).

44. See *id.* at 1454.

45. See *id.* at 1453.

account that bore MEC's name, while interest generated by the account was credited to Bristol. When MEC needed money, it applied to Bristol for capital appropriations.⁴⁶ Finally, MEC's board of directors had members who were not aware that MEC had a board or that they were members of it. Bristol's senior representative on MEC's board could not be outvoted by the other members.⁴⁷ In short, unlike Dow and Corning, Bristol did not treat its subsidiary as a distinct entity operationally and financially. Moreover, the internal corporate governance structure of the Bristol subsidiary lacked credibility as that of a distinct corporation, while Dow Corning's structure was taken seriously by its immediate participants and by the parent corporations.

To be sure, legal doctrine on these points is not a seamless web of logical consistency. In particular, circumstances that seem factually insufficient to support the imposition of substantive liability against a controlling shareholder may nonetheless carry significant procedural consequences. In *Polanco v. H. B. Fuller Co.*,⁴⁸ the plaintiff, a Guatemalan citizen, brought a wrongful death action in federal court against a United States corporation, the parent of a majority-owned Guatemalan subsidiary that manufactured glue to which plaintiff's decedent was addicted.⁴⁹ The plaintiff did not name the Guatemalan subsidiary as a defendant in the action. The question for the court was whether to impute or attribute the subsidiary's citizenship to the parent, with the effect of destroying diversity of citizenship between the plaintiff and the defendant and thereby eliminating federal subject matter jurisdiction.⁵⁰ Although the plaintiff abjured any intention to rely on veil piercing to impose liability on the parent corporation, the court noted that the plaintiff's argument was premised on the parent's control of the subsidiary, and that the plaintiff made at best only a weak and sketchy assertion of direct liability against the parent.⁵¹ The court attributed the subsidiary's citizenship to the parent, finding that attribution furthered Congress' intent to limit diversity jurisdiction. The procedural outcome in *Polanco* is paradoxical because the court also concluded that the underlying facts alleged by the plaintiff would not warrant piercing the corporate veil between the parent and its

46. See *id.* at 1450-52. In contrast, using a centralized cash management system is not a hallmark of domination. See *Fletcher v. Atex, Inc.*, 68 F.3d 1451, 1459 (2d Cir. 1995).

47. See *In re Silicone Gel Breast Implants Products Liab. Litig.*, 887 F. Supp. at 1450-53.

48. 941 F. Supp. 1512 (D. Minn. 1996).

49. *Id.*

50. See 28 U.S.C. § 1332(a)(2) (1994) (conferring diversity jurisdiction when controversy involves "citizen of a State and citizens or subjects of a foreign state"). The presence of a nondiverse party destroys diversity. See *Polanco*, 941 F. Supp. at 1515.

51. The plaintiff's theory of direct liability against the parent was a sketchy reference to "conceiving the design" of the glue. *Polanco*, 941 F. Supp. at 1516, 1518-19.

subsidiary.⁵² Thus, curiously enough, the parent's stock ownership automatically sufficed to impute the subsidiary's citizenship but not its acts to the parent!

C. *The Centrality of Control*

Some academic commentary challenges the centrality of control to questions of vicarious liability. In an analysis specifically focused on service station torts, but of much broader applicability, Professor Alan Sykes argues that many indicia of control lack economic significance.⁵³ In the cases studied, the plaintiff was injured through the negligence of a service station operator or an operator's employee and sought recovery from the oil company whose products the station sold. Most cases decline to impose liability on the oil company on the basis that its agreement with the station operator gave the operator control over the station's hours of operation, hiring and firing of employees, and prices charged for products.⁵⁴ In contrast, Professor Sykes argues that economically relevant factors include the duration of the relationship, the observability of loss-avoidance behavior, and other circumstances that indicate which party is a better risk bearer from the standpoint of economic efficiency.⁵⁵ Vicarious liability should be premised, in relationships of indefinite duration, on the dominant party's ability to "use incentives that are fairly inexpensive to enforce, such as threats of termination, to induce desired loss-avoidance efforts"⁵⁶ As the dominant party, the oil company has leverage over the station operator that could be used to improve safety conditions. This analysis is readily translatable into the parent-subsidiary relationship. The parent's ability to influence operational and financial decisions at the subsidiary level enables it to induce desired behavior, using subtle as well as more blatant mechanisms of control.

52. See *id.* at 1519-20. The attribution rule applied in *Polanco* originated in a line of Fifth Circuit cases, beginning with *Freeman v. Northwest Acceptance Corp.*, 754 F.2d 553 (5th Cir. 1985). No other circuit court has adopted the doctrine. The attribution doctrine was rejected in *Pyramid Secs. Ltd. v. IB Resolution, Inc.*, 924 F.2d 1114 (D.C. Cir.), *cert. denied*, 502 U.S. 822 (1991). *Pyramid* characterized the attribution doctrine as "anomalous" because it focuses on the subsidiary for jurisdictional purposes when the substantive claim is "about the parent." *Id.* at 1120.

53. Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231, 1264-65 (1984). In their treatment of limited liability questions, Judge Easterbrook and Professor Fischel do not mention control as a factor relevant to piercing the veil. Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 109-13 (1985). They conclude that courts pierce the veil "in situations where the incentive to engage in excessively risky activity is the greatest," which does not appear to reflect the significance of control as a factor. *Id.* at 117.

54. See Sykes, *supra* note 53, at 1264-65.

55. *Id.* at 1239.

56. *Id.* at 1265.

The premises that underlie this critique of assigning a central role to control are substantially at odds with fundamental presuppositions that underlie the common law of agency, as well as the body of cases applying the concept of domination to inter-corporate relationships. It is unsurprising that legal doctrine dominated by agency principles so strongly emphasizes the exercise of control as a determining factor. Agency is grounded in the concept that one person is a representative of another, such that it is fair to hold one person to the legal consequences of another's acts. The legal doctrine of agency reflects a sense of fairness that takes seriously the moral autonomy of individual actors, extending responsibility for wrongful acts from the agent to include the principal only when the principal has done something that makes the act the principal's own, including creating incentives that make it likely the agent will commit the act. If the principal lacks the right to control the agent as to the act in question, the agent is not acting as the principal's representative. Moreover, the entire relationship is not one of agency if no right of control is present.

Legal doctrine also reflects strong judicial deference to the ability of private sector actors to use legal form to inventive effect. Like the law of wills, corporate law enables people to create an institution of social significance that would not otherwise exist and to achieve ends that the law itself constitutes and defines.⁵⁷ Corporate law enables formal legal personality and structure to be given to private-sector organizations, which facilitates the accomplishment of objectives that require the coordinated activity of groups of individuals. Effective invention requires compliance with specified form and subsequent behavior consistent with the invention. Cases defer to the parent corporation's creation of a subsidiary and subsequent treatment of the subsidiary as a distinct person with interests of its own, declining to convert the parent's capacity for control into a duty to exercise operational control of the subsidiary.⁵⁸ When a shareholder does exercise direct and pervasive control, unmediated by regard for the subsidiary's corporate structure, its conduct attracts the pejorative language noted earlier in this article.

57. See Robert S. Summers, *How Law Is Formal and Why It Matters*, 82 CORNELL L. REV. 1165, 1225-27 (1997) (arguing that inventive aspects of law contribute beneficially to creation of new varieties of social and civil life).

58. See, e.g., *In re American Honda Motor Co., Inc. Dealerships Relations Litig.*, 958 F. Supp. 1045, 1051-1052 (D. Md. 1997) (noting "that a subsidiary is presumed to possess a free will, stemming from its corporate separateness, even on occasions of sin," and to adopt "a 'knowledge plus failure to remedy' approach would be to destroy legal fictions which have become business realities.").

III. CONTROL OVER DIRECTORS

Additional insights into the workings of control may be gleaned from controversies in which a minority shareholder challenges a transaction between the corporation and an allegedly dominant shareholder, when the transaction has been approved by the corporation's directors. A rich body of caselaw, principally from Delaware, considers the circumstances under which the court should review the substantive merits of such transactions, thereby dislodging the business judgment rule. The business judgment rule creates a presumption that, in making a decision, directors acted with care, without a conflicting interest, in good faith, and in the honest belief that the action taken was in the corporation's best interests.⁵⁹ If the presumption is not rebutted, the business judgment rule insulates directors' decisions from judicial review of their merits. Separately, these controversies raise questions about the role and duties of directors of corporations when the picture includes a substantial shareholder along with minority investors, especially a substantial shareholder that aggressively makes its wishes known. In this context, the reality that control can be exercised through indirect mechanisms has consequences that it does not have when the question is the controlling shareholder's liability for obligations incurred by the subsidiary corporation.

A. *Mechanisms of Control*

Questions about domination of directors often surface with an initial procedural tint associated with shareholder derivative actions: are the corporation's directors sufficiently independent of the shareholder-defendant, who benefited from the transaction, to be credible in assessing whether it is in the corporation's interests to sue the shareholder? Delaware caselaw is clear that, for this purpose, the mere fact that the corporation has a majority shareholder who elected the directors does not strip the directors of the presumptions of independence and good faith with which the business judgment doctrine invests directors.⁶⁰ To overcome the presumption of independence for this purpose, the plaintiff must allege facts "as would demonstrate that through personal or other relationships the directors are beholden to the controlling person,"⁶¹ or facts that, more broadly, call into doubt the director's capacity to bring independent judgment to bear on the question of how best to serve the corporation's interests regarding the pro-

59. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (citing *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971)).

60. See *id.* at 815.

61. *Id.*

posed lawsuit against the shareholder.⁶² If these barriers are surmounted, or if they are irrelevant because the suit asserts a direct claim on behalf of minority shareholders individually, not a claim derivatively on behalf of the corporation, the court reviews the merits of the transaction. The applicable standard is "entire fairness," which encompasses the dealings and conduct that led to the transaction, as well as the price.⁶³ The court does not defer to the directors' approval of the transaction.⁶⁴ The defendant bears the burden of proof on entire fairness unless the directors who approved the transactions were independent of the defendant, and unless the directors exercised actual bargaining power in arms-length negotiations with the controlling shareholder, who cannot simply dictate the terms of the transaction.⁶⁵ If these requirements are met, the plaintiff has the burden of proof, but the standard remains "entire fairness."⁶⁶

It is noteworthy that the Delaware court's rationale for dislodging the business judgment rule when directors approve a transaction with a majority shareholder is highly attuned to the prospects of subtle and indirect mechanisms of control that might be difficult to establish. In *Kahn v. Tremont Corp.*,⁶⁷ the court observed that the policy of substantive judicial review "is utilized because the underlying factors which raise the specter of impropriety can never be completely eradicated and still require careful judicial scrutiny," even when a committee of independent directors has negotiated the transaction.⁶⁸ The policy "reflects the reality that . . . the controlling shareholder will continue to dominate the company regardless of the outcome of the transaction,"⁶⁹ a position that enables it to retaliate against directors who are perceived as unsympathetic to its prerogatives. The risk of retaliation—even in the absence of an overt threat—means that the directors, however independent they may feel themselves to be, are never completely in the situation of arms-length bargaining. Nor do they appear to be so, a fact that suggests substantive judicial review serves a

62. See *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993).

63. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

64. See *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997). Earlier cases appear to have required the plaintiff to establish factually that a majority shareholder actually dominated the board before the entire fairness standard became applicable. See *Puma v. Marriott*, 283 A.2d 693, 695 (Del. Ch. 1971). If the shareholder holds less than a legal majority of shares, the entire fairness standard is applicable when the shareholder actually exercises control. See *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 70 (Del. 1989).

65. See *Kahn v. Tremont Corp.*, 694 A.2d at 429. A director is independent for these purposes if the director is free of ties to the defendant that would otherwise compromise the director's ability to bring objective judgment to bear. See *id.* at 429-30.

66. *Kahn v. Lynch Communications Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994).

67. 694 A.2d 422 (Del. 1997).

68. *Id.* at 428.

69. *Id.*

legitimizing function as well as a protective function on behalf of minority shareholders.

How the prospect of substantive judicial review affects the parties' behavior in structuring the transaction may vary. Realizing that the court will review the merits of the transaction, the parties may be especially careful to obtain reliable information and to structure the process so that the subsidiary's independent directors can function as credible representatives of the minority shareholders.⁷⁰ Another possibility, of course, is that the controlling shareholder will not bother negotiating with the subsidiary's independent directors, realizing that the court will examine the merits of the transaction however its terms were determined. A further possibility is that the parent will not pursue or will abandon a transaction that would be advantageous both to it and to the subsidiary's minority shareholders, having been inhibited by the risks of subsequent substantive judicial review.⁷¹

The underlying question is whether the standard applicable to litigation challenging a transaction between a parent corporation and a subsidiary plays a determining role in shaping the parties' behavior. The strongest argument against the court's position in *Tremont Corp.* is that the interests of minority shareholders are best protected by subsidiary-level directors who have the ability and willingness to say no to a transaction proposed by the parent.⁷² Holding out the carrot of the business judgment rule—that is, the prospect that the court would defer to the decision of those directors—may induce some controlling shareholders to refrain from aggressively imposing transactions by encouraging the parent to participate in processes that embody credible corporate governance on the part of the subsidiary. The court's resolution in *Tremont Corp.* may reflect a judgment that the likelihood such results will materialize is less likely than

70. See *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 933-34 (Del. 1985) (reporting that majority shareholder anticipated litigation challenging merger transaction, having been threatened with suit by minority shareholder, and "carefully sought to comply with applicable Delaware law in meeting the test of complete fairness.").

71. See John F. Johnston & Frederick H. Alexander, *The Effect of Disinterested Director Approval of Conflict Transactions Under the ALI Principles of Corporate Governance Project - A Practitioner's Perspective*, 48 BUS. LAW. 1393 (1993). It is difficult to assess how likely it is that this theoretical possibility would materialize. It presupposes the existence of a category of transactions from which both the parent and the minority would benefit that either would not withstand "entire fairness" review on the merits, or for which the litigation costs of establishing entire fairness appear prospectively to overwhelm the anticipated benefit.

72. *Kahn v. Tremont Corp.*, No. Civ. 12339, 1996 WL 145452, at *7 (Del. Ch., Mar. 21, 1996), *rev'd*, 694 A.2d 422 (Del. 1997).

an increase in difficult-to-detect forms of domination that disadvantage the interests of minority shareholders.⁷³

Indeed, recent cases feature controlling shareholders whose tactics in dealing with directors were not subtle. Consider the pattern of demands and threats made in *Kahn v. Lynch Communications Systems, Inc.*,⁷⁴ to persuade a committee of independent directors to approve transactions favored by the controlling shareholder. The controlling shareholder's energies focused first on its proposal that the subsidiary acquire a company within the shareholder's large corporate extended family. The proposal emerged after the subsidiary's management initially proposed an acquisition of an unrelated company, which the shareholder opposed. The shareholder's representative on the subsidiary's board then opposed the renewal of top management's compensation contracts. A representative of the shareholder told the subsidiary's directors, "[y]ou must listen to us. We are 43 percent owner. You have to do what we tell you."⁷⁵ Thereafter the board formed a committee of three independent directors to negotiate the terms of the acquisition favored by the shareholder. When the committee concluded, on the basis of its investment banker's advice, that the price demanded was too high, the shareholder withdrew the proposal and offered to buy out the noncontrolling shares in the subsidiary at \$14 cash per share. The committee, once again advised by its investment banker, responded with a counter offer of \$17 per share. The shareholder responded with successive offers at higher prices, concluding with a final price of \$15.50. The committee members, told that the shareholder would make a tender offer directly to the noncontrolling shareholders at a lower price if they did not accept the \$15.50 price, finally acquiesced.⁷⁶

Lynch Communications illustrates that directors who appear to exemplify independence and diligence may meet their match and be defeated by a truly intransigent shareholder, in this saga one willing to threaten proceeding with a transaction of lesser value to the noncontrolling shareholders. Additionally, this narrative illustrates the significant role played by professional advisors in aiding the subsidiary's directors in their dealings with the controlling shareholder. As the court observed in *Kahn v. Tremont Corp.*,⁷⁷ "in complicated financial transactions such as this, professional advisors have the ability to influence directors who are anxious to

73. The resolution in *Kahn v. Tremont Corp.* is consistent with the position taken in the ALI's Corporate Governance project. See 6 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.10 (1985).

74. 638 A.2d 1110 (Del. 1994).

75. *Id.* at 1114.

76. See *id.* at 1113.

77. 694 A.2d 422 (Del. 1997).

make the right decision but who are often *in terra cognito* [sic].”⁷⁸ If the advisors are chosen by the controlling shareholder, not the directors, or if the advisors’ performance is inhibited under the circumstances, the shareholder may more readily dominate the directors. Two cases better known for other propositions illustrate this point vividly. In *Virginia Bankshares, Inc. v. Sandberg*,⁷⁹ the controlling shareholder, a bank holding company, failed to effect a cash out of minority shareholders through a merger of its Maryland subsidiary.⁸⁰ The failure occurred after the holding company’s investment banker opined that the price offered was fair. The subsidiary’s directors retained their own financial advisor, concluded that the price was inadequate, and refused to proceed with the transaction. A year later, the holding company proposed a comparable cash out of minority shareholders in its Virginia subsidiary. The holding company’s investment bank opined that the price offered the minority was fair, solely on the basis of market quotations and unverified information it received from the holding company. A director of the subsidiary, who was also a director of the holding company, discouraged the directors from hiring their own advisor, fearing that independent advice would lead to a repeat of the Maryland experience.⁸¹

Separately, the leading Delaware case dealing with cash-out transactions, *Weinberger v. UOP, Inc.*,⁸² contains a memorable portrait of the investment banking profession performing at less than its best.⁸³ The subsidiary’s banker, a member of its board, prepared a fairness opinion regarding the price offered in a cash-out merger transaction. The opinion was prepared on the basis of a study of financial statements and a one-day due diligence visit to the subsidiary’s headquarters. The banker arrived at the directors’ meeting with a typed fairness opinion in which the price term had been left blank. The court noted that the parent’s rush to complete the transaction “contributed to the difficulties under which this investment banking firm attempted to perform its responsibilities.”⁸⁴

78. *Id.* at 429 (Del. 1997). In *Tremont Corp.*, the independent committee approved the purchase of shares in another corporation that were owned by a third corporation, within a complicated ownership pattern in which all corporations had the same dominant shareholder. The court noted with disapproval that the independent committee’s financial advisor had had “lucrative past dealings” with companies affiliated with the dominant shareholder, while the committee’s legal counsel was identified on the basis of a suggestion from the corporation’s general counsel and promptly retained by the committee. *Id.*

79. 501 U.S. 1083 (1991).

80. *Id.* at 1119.

81. *See id.*

82. 457 A.2d 701 (Del. 1983).

83. *Id.*

84. *Id.* at 712.

In contrast with cases in which the corporate veil is in jeopardy, in the cases just surveyed the salient point is that the dominant shareholder has manipulated the subsidiary's corporate "paraphernalia," not disregarded or ignored it. It is also evident that latent power itself does not always operate in straightforward ways. In *Virginia Bankshares*, displeased by the rebuff it received from the directors of its Maryland subsidiary, the majority shareholder could have attempted to remove the directors. However, this route would have succeeded only if the majority shareholder had the right to remove directors without cause⁸⁵ or, in the absence of such a right, if it could have established cause for removal, which did not seem likely under the circumstances.⁸⁶

Regardless of its prospects of effecting removal, the majority shareholder could in any event elect other people to the board when the current directors' terms expire and then propose the transaction again to a more complaisant or acquiescent audience. But both the removal and the replacement scenarios require a public and visible assertion of the majority shareholder's power, a prospect that invites adverse publicity, intensified regulatory scrutiny, and perhaps the close attention of entrepreneurial shareholders' lawyers. Latent power, at least in some contexts, thus may lose its effectiveness when it must be exercised in a more active and transparent form, a strategic circumstance that the directors of the Maryland subsidiary may have understood.

B. *Directors' Roles and Duties*

Scenarios in which directors are dominated by a controlling shareholder also invite reflection on the nature and extent of the directors' duties and potential liabilities to minority shareholders and third parties. The fact that the corporation has a majority shareholder does not relieve directors of their fiduciary duties of care and loyalty; domination is not a defense to claims arising from the breach of duties owed to minority shareholders or, for that matter, to nonshareholder third parties.⁸⁷ The cases surveyed above raise easy as well as difficult questions on this score. Approving a transaction to stay in the good graces of the majority shareholder

85. See, e.g., DEL. CODE ANN. tit. 8, § 141(k) (1991); MODEL BUS. CORP. ACT § 8.08 (1984).

86. Disagreeing with the controlling shareholder does not by itself represent the kind of conduct that constitutes cause for removal. Unlike agents in relationship to a principal, directors do not owe a duty of obedience to shareholders. See *supra* note 2 and accompanying text. The rationale for giving shareholders the power to remove directors for cause is to enable them to address directors' breaches of fiduciary duty, such as embezzlement or sharing trade secrets with a competitor. See *Campbell v. Loews, Inc.*, 134 A.2d 852, 857-58 (Del. Ch. 1957).

87. In the cases discussed in this portion of the article, with the exception of *Lynch Communications*, the plaintiff's complaint named at least some of the subsidiary's directors as defendants.

does not seem consistent with a director's duty of loyalty, especially when the transaction is not financially adequate in its treatment of minority shareholders.⁸⁸ Blessing a cash out price for the minority's shares, when there is no active trading market for the shares, solely on the basis of a fairness opinion furnished by the majority shareholder's investment banker, raises obvious questions about whether the directors discharged their duty of care.⁸⁹

Lynch Communications suggests harder questions. The independent directors finally acquiesced in the majority's proposed buy-out transaction, but only after a sequence of interactions that raised the price and culminated in the majority shareholder's threat to offer less in a tender offer. The independent directors had no choice that was very appealing. The majority's threat was credible because the corporation's stock was trading at a very low level.⁹⁰ But it may evidence a lack of good faith to vote in favor of a cash-out merger and recommend it to shareholders when a director harbors serious reservations about the fairness of the price. An additional choice for the directors is to resign, in the prospect that the parent will back off. A truly determined parent, though, may not be deterred by the directors' resignation or threatened resignation. It is interesting that the Delaware court ultimately decided the case in a manner that eliminated the immediate need to address this particular set of hard questions. The court found that the buy-out transaction met the entire fairness standard on the basis that the price paid by the majority shareholder was itself a fair price. Moreover, the court reasoned, the majority's coercive conduct toward the directors was not a material influence on the shareholders' decision to sell by voting in favor of the merger.⁹¹ The majority should not be faulted, the court observed, "for taking advantage of the objective reality of Lynch's financial situation,"⁹² which implies that the directors are not to be faulted for acquiescing rather than resigning.

88. The directors in *Virginia Bankshares* were alleged to have done so. See *Virginia Bankshares*, 501 U.S. 1083, 1088 (1991).

89. In Delaware, directors breach their duty of care if they approve a fundamental transaction, like a merger, without the benefit of relevant information that is reasonably available, including expert analyses of financial and valuation questions that in-house or outside experts might provide. See *Smith v. Van Gorkom*, 488 A.2d 858, 876-77 (Del. 1985). A subsequent shareholder vote, in itself, is not a defense to the directors' breach of duty, at least in the merger context. See *id.* at 873. As the court interprets it, DEL. CODE ANN. tit. 8, § 251(b) imposes on directors a duty to act in an informed and deliberate manner before submitting a merger proposal to stockholders. The shareholder vote is effective to ratify the directors' breach of duty only if the shareholders were fully informed of all facts material to the vote. See *Smith*, 488 A.2d at 890.

90. See *Kahn v. Lynch Communication Sys., Inc.*, 669 A.2d 79, 87 (Del. 1995) (at the time Lynch considered initial acquisition transaction, closing price of stock was \$11/share).

91. See *id.* at 86-88.

92. *Id.* at 85.

C. *Directors or Delegates*

A separate question is how best to characterize the relationship between directors of a subsidiary and the parent corporation. Even when the parent owns all the stock in the subsidiary, its directors are not agents of the parent. The parent, once having elected directors, does not have a right thereafter to interfere. To impose a duty of obedience on directors, moreover, would conflict with the fundamental point that corporate law assigns ultimate managerial power and responsibility to directors.⁹³ The parent thus lacks the right to assert control through interim instructions, a defining hallmark of a legal relationship of agency.⁹⁴ This is not a point of merely formal or definitional significance. As the preceding discussion illustrates, the distinction between a right of control and the effective power to control often has practical consequences. In the absence of a right to control the directors it elects, the parent must either disregard their existence, a move disrespectful of the corporate paraphernalia that jeopardizes the corporate veil insulating the parent from subsidiary-level liabilities, or the parent must take steps to exercise its power by coercing the directors or removing them, moves that have drawbacks of their own. To be sure, directors of a wholly-owned subsidiary owe fiduciary duties to their shareholders,⁹⁵ but that fact does not make them the shareholders' agents.

In many respects, directors who are not independent of the parent function as the parent's delegates—its eyes, ears, and voice—within the

93. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (1991). The Model Business Corporation Act, however, expressly invites arrangements to the contrary. See *supra* note 14.

94. See RESTATEMENT (SECOND) OF AGENCY § 14M, cmt. a. (1958) But see Eric J. Gouvin, *Resolving the Subsidiary Director's Dilemma*, 47 HASTINGS L.J. 287, 297-300 (1996) (characterizing as "quasi-agents" directors of subsidiaries of bankholding companies, with effect that duties ordinarily imposed on directors are passed to parent corporations).

95. See *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*, 545 A.2d 1171, 1174 (Del. 1988) ("[I]n a parent and wholly-owned subsidiary context, the directors of the subsidiary are obligated only to manage the affairs of the subsidiary, in the best interests of the parent and its shareholders;" court holds directors of wholly-owned subsidiary are not fiduciaries on behalf of prospective shareholders even after initiation of spin-off transaction but prior to its completion). Corporation statutes recognize that a corporation might request that a person serve as an officer, director, employee, or agent of another corporation or type of firm, or as a fiduciary of an employee benefit plan, in provisions that grant power to the requesting corporation to indemnify such persons against litigation-related costs stemming from their service. See, e.g., DEL. CODE ANN. tit. 8, § 145(a), (i). A corporation lacks power to indemnify unless the proposed indemnitee acted in good faith and in what was reasonably believed to be the best interests of the corporation. See *id.* § 145(a). Section 145(a) itself does not specify which corporation counts as "the" corporation. If the proposed indemnitee serves as a fiduciary of an employee benefit plan, subsection 145(i) deems a decision made in the reasonable belief that it serves the best interests of the plan's participants and beneficiaries to have been made to serve the best interests of "the corporation." *Accord*, MODEL BUS. CORP. ACT § 8.51(b) (1984). The Delaware statute does not address the question when the proposed indemnitee has otherwise served a corporation's request.

subsidiary's boardroom.⁹⁶ Such directors are often a two-way channel of communication between the parent and the subsidiary's other directors and its management, relaying the parent's views and preferences and reporting back information of interest to the parent. In *Weinberger*, for example, subsidiary directors who were also officers of the parent corporation performed a financial feasibility study to assist the parent in structuring a transaction to cash out the subsidiary's minority shareholders. Although the study was derived from the subsidiary's information, the directors who prepared the report shared it only with senior management and directors of the parent, but not with the subsidiary's outside directors or with its minority shareholders.⁹⁷

As the parent's delegates, nonindependent directors are a conduit for the expression of its interests. To the extent they serve as the parent's agents, the scope of their agency is limited to the faithful expression of the parent's instructions and, if so instructed, faithful reporting back to the parent.⁹⁸ The scope of the agency does not encompass decisions directors make that implicate the interests of the corporation. A broader scope is inconsistent with deeply entrenched assumptions about corporate governance, in particular the norm that the board of directors is not a "passive instrumentality."⁹⁹ Moreover, an actor's fiduciary status—whether as an agent, a corporate officer, or a director—is not a defense to the actor's breach of a duty owed to a third party.¹⁰⁰ To be sure, the practical demands of specific regulatory contexts could warrant a redesign of corporate governance limited to that context.¹⁰¹ As a general matter, though, the cases discussed in this section of the article illustrate that it can be both feasible and worthwhile to treat subsidiary directors, not as the parent's agents, but

96. The term 'delegate' (like 'ambassador') suggests an actor sent on orders with a message or instructions. See HANNAH F. PITKIN, *THE CONCEPT OF REPRESENTATION* 121, 133 (1967).

97. See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 708-09 (Del. 1983).

98. It is a separate question whether such a transmission of information would violate the director's duty to the corporation to respect the confidentiality of information the director receives. An agent's duty to give the principal relevant information as to matters entrusted to the agent does not extend to information the agent cannot reveal without violating a superior duty to a third person. See RESTATEMENT (SECOND) OF AGENCY § 381.

99. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) ("[I]n the broader context of corporate governance, including issues of fundamental corporate change, a board of directors is not a passive instrumentality.").

100. See Thompson, *supra* note 37, at 25-27; RESTATEMENT (SECOND) OF AGENCY § 359A (stating principal's command does not relieve agent of criminal liability for conduct otherwise a crime); *id.* § 343 (stating agent not relieved of liability for conduct otherwise constituting a tort because agent acted at principal's command or on principal's behalf). Ethical rules applicable to lawyers include a controversial exception for associates in law firms who act "in accordance with a supervisory lawyer's reasonable resolution of an arguable question of professional duty." MODEL RULES OF PROFESSIONAL CONDUCT RULE 5.2(b). See also Carol M. Rice, *The Superior Orders Defense in Legal Ethics: Sending the Wrong Message to Young Lawyers*, 32 WAKE FOREST L. REV. 887 (1997).

101. See Gouvin, *supra* note 94.

as the governing body of a separate corporation. Even when the subsidiary has no minority equity investors, third party relationships with the subsidiary give it interests that are not identical with those of the parent, as the cases surveyed in the first part of this article demonstrate.

IV. CONCLUSION

The article has illustrated the many forms—direct and indirect, blatant and subtle—that control may take in relationships between corporations. Relationships that create the ability to dominate do not necessarily create a right to control, a distinction with practical as well as theoretical consequences. The article also illustrates that courts have been responsive to the reality of indirect mechanisms of control when the focus of the litigation is self-dealing by the controlling shareholder, but relatively indifferent when the litigation challenges the corporate veil that shields the parent from liability for obligations incurred at the subsidiary level. The contrast demonstrates the depth at which the assumption of autonomous legal personality is entrenched, as well as the profound significance of legal form within corporate law.

